

## Message Text

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INFO OCT-01 EA-10 IO-13 ISO-00 SP-02 USIA-06 AID-05  
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R 171651Z MAR 78  
FM AMEMBASSY LONDON  
TO SECSTATE WASHDC 4263  
TREASURY DEPT WASHDC  
INFO AMEMBASSY BONN  
AMEMBASSY BRUSSELS  
AMEMBASSY DUBLIN  
AMEMBASSY PARIS  
AMEMBASSY ROME  
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DEPARTMENT PASS FEDERAL RESERVE BOARD; TREASURY FOR  
DONALD E. SYVRUD, OASIA

E.O. 11652: N/A  
TAGS: UK, EFIN, EGEN  
SUBJECT; THE NATIONAL INSTITUTE'S QUARTERLY ECONOMIC  
REVIEW  
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SUMMARY: THE NATIONAL INSTITUTE FOR ECONOMIC AND SOCIAL  
RESEARCH (NIESR) CALLS FOR A MORE RATIONAL INCOMES POLI-  
CY MECHANISM AND A SUBSTANTIALLY SMALLER RISE IN AVER-  
AGE EARNINGS IN THE NEXT PAY ROUND. NIESR CONTINUES TO  
URGE RESISTANCE TO ANY UPWARD PRESSURE ON STERLING. THE  
SHARPEST BARBS IN NIESR'S FIRST QUARTERLY ECONOMIC RE-

VIEW FOR 1978 ARE RESERVED FOR ADVOCATES OF MONETARY TARGETRY AS THE MOST APPROPRIATE VEHICLE FOR MONETARY POLICY. NIESR'S FORECASTS FOR 1978 AND 1979 ARE FOR YEAR-ON-YEAR REAL GROWTH OF 2.7 AND 2.5 PERCENT RESPECTIVELY, A CURRENT ACCOUNT SURPLUS IN EACH YEAR OF 1.3 BILLION POUNDS, AND HIGH SINGLE DIGIT INFLATION OVER THE PERIOD. END SUMMARY.

1. THE BULK OF THE APPRAISAL SECTION OF NIESR'S FEBRUARY ECONOMIC REVIEW IS GIVEN OVER TO A RATHER CAUSTIC CONTRIBUTION TO THE DEBATE OVER MONETARY TARGETS OPENED BY THE GOVERNOR OF THE BANK OF ENGLAND. NIESR TAKES AS GIVEN THAT THERE IS NEITHER A STRONG NOR STABLE SHORT-RUN LINK BETWEEN CHANGES IN THE MONEY SUPPLY AND CHANGES IN NATIONAL INCOME, NOR IS THERE ONE BETWEEN VARIATIONS IN THE MONEY SUPPLY AND REAL OUTPUT ON THE ONE HAND AND PRICES ON THE OTHER. IN ITS VIEW, THE DEBATE TURNS ON THE APPROPRIATENESS OF A MONETARY TARGET AS A VEHICLE FOR MONETARY POLICY. IT CHARACTERIZES PART OF THE CASE FOR TARGETS AS NEGATIVE SINCE AN ENVIRONMENT OF RAPIDLY CHANGING EXPECTATIONS MAKES IT DIFFICULT TO FRAME MONETARY POLICY OBJECTIVES IN TERMS OF NOMINAL INTEREST RATES. THEREFORE, CLEAR MONEY SUPPLY TARGETS HELP TO DAMPEN THE VOLATILITY INDUCED BY RAPIDLY CHANGING EXPECTATIONS.

2. NIESR IS NOT OPPOSED TO THE PROMOTION OF STABLE EX-LIMITED OFFICIAL USE

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PECTATIONS BUT STRONGLY OBJECTS TO THE IMPLICATION THAT FISCAL POLICY SHOULD BE SUBORDINATED TO THE ACHIEVEMENT OF A GIVEN MONEY SUPPLY TARGET. RATHER, THE TARGET SHOULD BE ACHIEVED THROUGH FINANCIAL MARKET OPERATIONS, NOT BY ADJUSTMENT OF REAL MARKETS. THIS ANALYSIS BUT-TRESSES NEISR'S CALL FOR A FISCAL STIMULUS IN THE COMING BUDGET.

3. TURNING TO THE RELATIONSHIP BETWEEN MONETARY POLICY AND THE FOREIGN EXCHANGE MARKETS, NIESR ADMITS THAT AN ACTUAL OR EXPECTED BREACH OF THE TARGET COULD EXERT POWERFUL EFFECTSON CONFIDENCE. IT NOTES THAT THE RESULTING OUTFLOW WOULD DEPRESS THE EXCHANGE RATE AND AFFECT REAL MARKETS, AS WOULD A CORRESPONDING EFFORT BY THE AUTHORITIES TO STEM THE BREACH BY WIDENING THE DIFFERENTIAL BETWEEN DOMESTIC AND FOREIGN INTEREST RATES. IN NEITHER CASE MIGHT THE UNDERLYING STATE OF THE ECONOMY WARRANT SUCH EXCHANGE RATE OR FISCAL POLICY CHANGES.

4. NIESR CONCLUDES BY REITERATING ITS VIEW THAT THE CASE FOR MONETARY TARGETS AS AGENTS FOR DAMPENING INFLATIONARY EXPECTATIONS HAS NOT BEEN PROVEN. RATHER, NIESR AR-

GUES THAT IF A TARGET IS SET "IT SHOULD BE SUFFICIENTLY  
HIGH ENOUGH TO AVOID CHANGES IN FISCAL STANCE AND IN THE  
EXCHANGE RATE WHICH WOULD NOT OTHER WISE BE JUSTIFIED,  
AND AT THE SAME TIME LOW AND FIRM ENOUGH TO PRESERVE ITS  
(ALBEIT IN OUR VIEW DOUBTFUL) ROLE IN REDUCING INFLATION-  
ARY EXPECTATIONS. IN THE PRESENT CONJUNCTURE, IT IS NOT

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R 171651Z MAR 78  
FM AMEMBASSY LONDON  
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AT ALL CLEAR THAT BOTH THESE CRITERIA CAN BE SATISFIED."  
THE INCREASE IN EARNINGS IS THE FIGURE WHICH NIESR BE-  
LIEVES TO BE MOST SIGNIFICANT IN REDUCING INFLATION. AT-  
TENTION SHOULD BE FOCUSED ON DIRECT MEANS OF BRINGING  
THAT FIGURE DOWN.

5. THE REST OF THE APPRAISAL IS DEVOTED TO SHORT COMMENTS ON THE COMING BUDGET, INCOMES POLICY AND EXCHANGE RATE POLICY. NIESR CALLS FOR A NET BUDGETARY STIMULUS (2.5 LIMITED OFFICIAL USE

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BILLION POUNDS) JUST LARGE ENOUGH TO KEEP UNEMPLOYMENT FROM RISING. IT OPINES THAT THE IMPORT CONSEQUENCES OF SUCH A STIMULUS WOULD BE SMALLER WERE IT WEIGHTED TOWARD HIGHER PUBLIC EXPENDITURE RATHER THAN LOWER TAXES. ON PAY POLICY, NIESR CRITICIZES THE CRUDE, HAPHAZARD AND SECRETIVE NATURE OF THE CURRENT POLICY. IT URGES A SUBSTANTIALLY LOWER RISE IN EARNINGS IN THE NEXT PAY ROUND THAN THE 15 PERCENT IT EXPECTS IN THE CURRENT ROUND. NIESR IS STRONGLY OF THE VIEW THAT THE STRAINS AND ANOMALIES CHARACTERISTIC OF THE PRESENT WAGE RESTRAINT CAN BE ALLEVIATED BY MOVEMENT TOWARD A MORE RATIONAL POLICY. IN LINE WITH ITS VIEW ON MONETARY TARGETS, IT ARGUES THAT EXCHANGE RATE POLICY SHOULD NOT BE HELD HOSTAGE TO MONETARY POLICY, THAT THE OCTOBER 31, 1977 DECISION TO LET STERLING FLOAT TO EASE MONEY SUPPLY GROWTH WAS MISGUIDED AND THAT FURTHER UPWARD PRESSURE ON THE EXCHANGE RATE SHOULD BE RESISTED.

6. THE FORECAST. THE FOLLOWING TABLE SUMMARIZES NIESR'S FORECASTS FOR 1978 AND 1979:

	1977	1978	1979
REAL GDP (PERCENT CHANGE, YEAR/YEAR)	-0.1	2.7	2.5
REAL PERSONAL DISPOSABLE INCOME (PERCENT CHANGE, YEAR/YEAR)	-2.0	4.3	2.7
UNEMPLOYMENT (4TH QUARTER, MILLION)	1.4	1.4	1.5
MONEY SUPPLY (PERCENT CHANGE IN STERLING M3, FISCAL YEARS)	13.0	16.3	14.5
CONSUMER PRICES (PERCENT CHANGE, YEAR/YEAR)	14.5	8.5	9.8
CURRENT ACCOUNT BALANCE (YEAR, POUNDS BILLION)	0.1	1.3	1.3

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PUBLIC SECTOR BORROWING REQUIREMENT (FISCAL YEAR, POUNDS BILLION)

	6.7	9.4	9.9
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THE PRINCIPAL ASSUMPTIONS OF THE FORECAST ARE:  
-- A 2.0 BILLION POUND INCOME TAX CUT IN THE APRIL BUDGET;

- FREELY FLOATING EXCHANGE RATE;
- A GROWTH RATE OF 16.3 PERCENT IN STERLING M3;
- A RISE OF 15 PERCENT IN AVERAGE EARNINGS IN THE  
CURRENT PAY ROUND FOLLOWED BY A RISE OF 12  
PERCENT IN THE FOLLOWING ROUND;
- A 4.5 PERCENT RISE IN WORLD TRADE IN MANUFACTURES  
IN 1978.

ON THESE ASSUMPTIONS, NIESR EXPECTS "A MILD RECOVERY  
IN 1978 FUELLED BY A RECOVERY IN CONSUMER EXPENDITURE AND  
PRIVATE INVESTMENT. CURRENT GOVERNMENT EXPENDITURE IS  
EXPECTED TO RISE BY ABOUT 2 PERCENT IN REAL TERMS. HOW-  
EVER, THIS WILL BE MORE THAN OFFSET BY LOWER INVESTMENT  
IN NATIONALIZED INDUSTRIES WITH OVERALL GOVERNMENT EX-  
PENDITURE DECLINING BY LESS THAN 1 PERCENT INVOLUME TERMS

7. GDP IS FORECAST TO GROW BY 3-3/4 PERCENT THRU 1978  
WHICH IS THOUGHT TO BE SUFFICIENT TO HOLD UNEMPLOYMENT  
CONSTANT. REAL TOTAL PUBLIC EXPENDITURE IS NOT ANTICI-  
PATED TO CONTRIBUTE A GREAT DEAL TO GROWTH, RISING BUT  
1-1/2 PERCENT IN 1978 AND 2-1/2 PERCENT IN 1979. THE

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MODEST RISE IN EXPENDITURE WILL STILL LEAVE NIESR'S MEASURE OF A "HIGH EMPLOYMENT PUBLIC SECTOR FINANCIAL BALANCE" IN SURPLUS. THE HIGH EMPLOYMENT BALANCE, HOWEVER, IS ESTIMATED TO DECLINE TEMPORARILY TO 1.6 BILLION POUND IN 1978/79 FROM THE 3 BILLION POUND LEVEL ESTIMATED FOR 1977/78 AND FORECAST FOR 1978/79.

8. THE PSBR IS FORECAST TO REACH 9.4 BILLION POUNDS IN 1978/79 AND 9.9 BILLION POUNDS IN 1979/80. THIS OVERSTEPS LIMITED OFFICIAL USE

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THE CEILING OF 8.6 BILLION POUNDS FOR 1978/79 MENTIONED IN THE LETTER OF INTENT TO THE IMF BUT NIESR COMMENTS THAT THE "DIFFERENCE SHOULD BE REGARDED AS WELL WITHIN THE POSSIBLE MARGIN OF FORECASTING ERROR." (NIESR DOES NOT ENTER INTO A DISCUSSION OF WHETHER THEY BELIEVE THE GOVERNMENT USES BIASED FORECASTS OR WHETHER IT INTENDS TO BREACH THE 8.6 BILLION POUND FIGURE, WHICH QUESTIONS NATURALLY ARISE FROM THEIR ASSERTION.) IT IS ANTICIPATED THAT SO LARGE A PSBR WILL PUT PRESSURE ON THE MONEY SUPPLY IN 1978/79, AND THAT GILT SALES WILL BE marginally LOWER THAN 1977/78. THIS IS BELIEVED TO GIVE A 16 PERCENT INCREASE IN THE MONEY SUPPLY (STERLING M3) FOR 1978/79.

9. THE CURRENT ACCOUNT IS FORECAST TO BE 1.3 BILLION POUNDS IN SURPLUS BOTH IN 1978 AND 1979. THIS REPRESENTS YET ANOTHER DOWNWARD REVISION AND ARISES IN THE MAIN FROM LOWER FORECASTS OF THE INVISIBLE SURPLUS. A SHARP JUMP IN THE TERMS OF TRADE INDEX FROM 81.7 IN 1977 TO 86.8 IN 1978 IS FORECAST. SUCH A FORECAST ARISES FROM CONSIDERING INDIVIDUAL PRICE MOVEMENTS IN MARKETS THAT ARE TACITLY ASSUMED TO BE HIGHLY SEGMENTED. FOREIGN CURRENCY PRICES OF THE U.K.'S COMPETITORS ARE JUDGED TO RISE 4 PERCENT IN 1978, WHILE U.K. WHOLESALE STERLING PRICES RISE 10 PER CENT AND STERLING APPRECIATES 6 PERCENT. STERLING PRICES OF IMPORTED GOODS ARE ON THE OTHER HAND EXPECTED TO FALL ABOUT 2 PERCENT AS A RESULT OF APPRECIATING STERLING AND SOFT COMMODITY MARKETS. PROFITABILITY OF EXPORTS FALL EVEN AS THE TERMS OF TRADE RISE.

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## Message Attributes

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